

No. 14579

**In the United States Court of Appeals
for the Ninth Circuit**

E. J. MURRAY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

**ON PETITION FOR REVIEW OF THE DECISION OF THE TAX
COURT OF THE UNITED STATES**

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The opinion of the Tax Court (R. 51-77) is reported at 21 T.C. 1049.

JURISDICTION

The petition for review (R. 80-85) involves a deficiency of \$36,656.04 in income tax for 1947. A notice of deficiency was mailed to the taxpayer on August 13, 1951. (R. 14.) Within ninety days thereafter and on November 7, 1951, the taxpayer filed with the Tax Court a petition for redetermination, under the provisions of Section 272 of the Internal Revenue Code of 1939. (R. 6-26.) The decision of the Tax Court was entered on July 26, 1954. (R. 79.) The case was

brought to this Court by a petition for review filed by the taxpayer on October 14, 1954. (R. 80-85.) Jurisdiction is conferred on this Court by Section 7482 of the Internal Revenue Code of 1954.

QUESTION PRESENTED

Whether the Tax Court correctly held that the taxpayer, who was on a cash basis, realized income in 1947, within the meaning of Section 42 of the Internal Revenue Code of 1939, to the extent of the net rentals credited to him in that year in connection with the final accounting and adjudication in a suit commenced in 1938, to establish his ownership of certain realty and his right to the net rentals therefrom.

STATUTE AND REGULATIONS INVOLVED

The applicable provisions of the statute and Regulations will be found in the Appendix, *infra*.

STATEMENT

The facts in this case have been stipulated (R. 31-51) and, as stipulated and found by the Tax Court, may be summarized as follows:

In 1928, E. J. Murray, referred to as the taxpayer, and his wife, Rebecca J. Murray, purchased as tenants by the entirety certain unimproved real estate situated in Klamath Falls, Oregon. To finance construction of a building on the property (the property and its improvements will be referred to as the Murray Building), the taxpayer and his wife borrowed \$64,000 from the Pacific Savings & Loan Association, Tacoma, Washington, giving in return a first mortgage on the property. (R. 53-54.)

On August 20, 1932, there was a balance of approxi-

mately \$57,000 due on the loan. On that date, the taxpayer and his wife conveyed the Murray Building to the Conger Corporation, an Oregon corporation, by deed warranting against all encumbrances except "existing mortgage, liens and taxes." The Conger Corporation was organized on August 5, 1932. Its sole stockholders were W. A. Wiley, G. Q. D'Albini and Marie D'Albini, wife of G. Q. D'Albini. Wiley and D'Albini were the taxpayer's attorneys and the taxpayer was indebted to them for professional services theretofore rendered. The transaction was handled in the following manner: Wiley and D'Albini borrowed \$5,000 from a bank and deposited it to the credit of the Conger Corporation in purported payment for its stock. The Conger Corporation then issued its check for \$5,000 to the taxpayer as purported consideration for the deed of the property to the corporation, whereupon the taxpayer returned the money to the lending bank in liquidation of the bank's loan to Wiley and D'Albini, whose notes were returned to them. The taxpayer also paid a \$10 charge for the use of the money. (R. 54.)

In May, 1934, the Pacific Savings & Loan Association brought suit to foreclose its first mortgage on the Murray Building and on March 23, 1935, the property was sold pursuant to a decree of foreclosure for the unpaid balance of \$56,984.78. The mortgagee was the purchaser. (R. 54-55.)

On March 21, 1936, the Conger Corporation, which appeared as the record owner of the Murray Building, gave notice of intention to redeem the property. On March 23, 1936, which was the last day of the statutory redemption period, the Conger Corporation assigned

the right of redemption and delivered a bargain and sale deed to the Murray Building to Mary L. Moore, Merle S. West, Charles J. Martin and Thomas B. Watters, referred to as the Watters Group. On the same day the Watters Group exercised their purported right of redemption by redeeming the property, paid to the Sheriff of Klamath County the sum of \$63,711.60, entered into possession, and thereafter claimed to be the owners in fee of the property, free from any claim of the taxpayer. (R. 55.)

At the time of the conveyance of the Murray Building to the Watters Group, the property was subject to liens for federal income tax in the amount of \$3,148.60 assessed against the taxpayer and Rebecca J. Murray. In November, 1936, the Watters Group advised the Deputy Collector in charge of collection of such tax to sell the property at public sale and that the Watters Group would buy it at such sale, thereby better perfecting their title. In April, 1937, the United States Collector of Internal Revenue, Portland, Oregon, proceeded to sell the Murray Building to collect the tax, and it was bid in by the Watters Group for \$16,500. The Watters Group was forced to pay that price by competitive bids although the tax liens amounted only to \$3,148.60. (R. 55-56.)

On March 22, 1938, the taxpayer and his wife filed suit in the Circuit Court of Oregon for the County of Klamath entitled "E. J. Murray and Rebecca J. Murray, Plaintiffs, v. W. E. Wiley, G. Q. D'Albini, Marie N. D'Albini, Mary L. Moore, Merle S. West, Emma West, Charles J. Martin, Lynna Martin, Thomas B. Watters, Evelyn Watters, and J. W. Maloney as Collector of Internal Revenue for the United States of

America, Defendants," wherein it was prayed that the court (a) decree that the plaintiffs were the beneficial owners of all right, title and interest in and to the Murray Building, (b) decree that the defendants, other than J. W. Maloney, were trustees holding the premises for the sole and exclusive benefit of the plaintiffs, (c) direct the defendants as trustees to convey the property to plaintiffs, and (d) require the defendants to render an accounting with respect to the operation of the Murray Building. On Motion, defendant J. W. Maloney was dismissed for lack of jurisdiction of the court. (R. 56.)

Rebecca J. Murray died on August 8, 1938, prior to hearing in the above entitled litigation. The taxpayer succeeded to her right, title and interest in the Murray Building as surviving tenant by the entirety. (R. 56.)

On December 18, 1940, the Circuit Court of Oregon, by written opinion, held for the defendants. The taxpayer took an appeal to the Supreme Court of Oregon. (R. 56-57.)

On June 30, 1942, the Supreme Court of Oregon, in *Murray v. Wiley*, 169 Ore. 381, 127 P. 2d 112, reversed the lower court and held (R. 57):

(a) That the taxpayer's conveyance of the Murray Building to the Conger Corporation was made to secure his indebtedness to his attorneys, Wiley and D'Albini, and that the Conger Corporation was the *alter ego* of Wiley and D'Albini, who were in the position of second mortgagees.

(b) The Conger Corporation held the property as a mortgagee in possession and its purported assignment of the statutory right of redemption affected property

belonging to the taxpayer and not to Wiley and D'Albini.

(c) The Watters Group, which received a conveyance from the Conger Corporation together with an assignment of the right of redemption were the assignees of rights which in equity belonged to the taxpayer and upon exercising the statutory right of redemption became mortgagees in possession, having the right to foreclose against the taxpayer but being subject to his right to redeem upon payment of the sums found to be due them.

(d) The taxpayer was the beneficial owner of the property subject to the liens of the various defendants who were mortgagees in possession.

The Supreme Court ordered the proceeding remanded for an accounting, directing that the defendants were entitled to (R. 57-58):

1. Credit of \$63,711.60 paid in redeeming the property, plus interest at six percent per annum from the date of payment.

2. Credit of the amount of the federal tax lien against the property with interest at six percent per annum and to receive from the Collector the balance of funds in his hands over the amount needed to satisfy such lien.

3. Reasonable fees for the legal services performed by Wiley and D'Albini prior to and owing on August 20, 1932, less offsets for certain cash realized by Wiley and D'Albini on their sale to the Watters Group. Defendants Wiley and D'Albini were also entitled to a lien subsequent to that of the Watters Group for any excess of the attorneys' fees remaining unpaid after crediting such cash offsets.

Upon full accounting being had, covering the matters indicated and all dealings by the Watters Group as mortgagees in possession, the Supreme Court of Oregon ordered that a decree be entered fixing the amount, if any, in which the Murray Building would be subject to a lien in favor of the Watters Group and also fixing the amount, if any, in which the Murray Building would be subject to a subsequent lien in favor of Wiley and D'Albini for attorneys' fees. The decree was to provide that, upon payment to the Watters group and Wiley and D'Albini of the amounts of their respective liens, the defendants were directed to reconvey the property to the taxpayer. In default of such reconveyance, the decree was to stand in lieu thereof. (R. 58-59.)

Thereafter, the defendants petitioned the Supreme Court of Oregon for rehearing, and on September 29, 1942, that court denied the petition, adding (R. 59) :

(a) That matters relating to the defendants' credits for cost of management and repairs to the Murray Building could be determined only by a subsequent accounting and not on the record then before the court.

(b) That the proceeding was a suit by a mortgagor to redeem and not by a mortgagee to foreclose; therefore the previous opinion was modified to provide that, unless the taxpayer did redeem the property from the liens, the decree of the Circuit Court should specify a reasonable time within which he might redeem from both liens or be forever barred.

The matter was returned to the Circuit Court of Oregon, and hearing was held upon the disputed issues arising from the accounting of the defendant mortgagees in

possession. The Circuit Court of Oregon held that (R. 59-60) :

(a) The defendants were entitled only to interest at six percent on \$65,000 paid to redeem.

(b) The defendants were not entitled to credit of the \$16,500 paid on the tax foreclosure sale but were entitled to \$3,152.95, the amount of the lien, and the expenses of the public sale, together with interest thereon at six percent per annum.

(c) The defendants were not entitled to credit for fees for supervision of the property.

(d) The defendants were not entitled to a credit for premiums paid on insurance policies on the Murray Building from which the taxpayer received no benefit.

(e) The defendants were not entitled to fees paid in attempting to get a refund of the excess paid to the Collector of Internal Revenue over the amount of the lien against the property.

(f) The defendants were not entitled to credit for accounting expenses in preparing their account in the action.

(g) The taxpayer was not entitled to surcharge the defendants for alleged mismanagement of the Murray Building.

The Circuit Court found a balance due on the accounting of rents and profits in favor of the defendants and entered judgment against the taxpayer. (R. 60.)

Both parties appealed this decision to the Supreme Court of the State of Oregon, which, by written opinion dated January 14, 1947, reported as *Murray v. Wiley*, 180 Ore. 257, 176 P. 2d 243, affirmed the trial court in all issues except that it directed that the decree be modified

to provide that the defendants have a lien upon the mortgaged property in the amount of the ascertained balance and eliminated the personal judgment against the taxpayer. The cause was remanded to the trial court for a further accounting of the rents and profits as to the period subsequent to that covered by the previous accounting. The Circuit Court was again directed to specify a reasonable time within which the taxpayer might redeem from the lien of the mortgage or be forever barred by the dismissal of his suit. (R. 60-61.)

On or about February 28, 1947, the defendants served upon the taxpayer an accounting of the rents and profits of the property. The following is a recapitulation of the accounting (R. 61):

Statement of Account	February 28, 1947	
Redemption Certificate.....	\$ 65,000.00	
Interest on \$65,000 at 6% from March 23, 1936, to February 28, 1947.....	42,658.87	\$107,658.87
Collector of Internal Revenue, tax lien.....	3,152.95	
Interest on \$3,152.95 at 6% from April 26, 1937 to February 28, 1947.....	1,862.36	5,015.31
Disbursements, March 23, 1936, to February 28, 1947.....	25,501.01	
Interest at 6% on monthly balances of disbursements, March 23, 1936, to February 28, 1947.....	8,273.31	33,774.32
Total disbursements, March 23, 1936, to February 28, 1947.....		\$146,448.50
Receipts, March 23, 1936, to February 28, 1947...	102,589.45	
Interest at 6% on monthly balances of receipts, March 23, 1936, to February 28, 1947.....	33,218.74	135,808.19
Balance February 28, 1947.....		<u>\$ 10,640.31</u>

On February 28, 1947, the taxpayer paid to the Clerk of the Circuit Court of the State of Oregon the sum of \$10,640.31. Thereupon, a final decree was entered, declaring that the taxpayer had satisfied in full all liens upon the property and was thereby entitled to have the legal title reconveyed to him. The defendants were directed to reconvey to him within ten days or have the

reconveyance occur through operation of the decree. (R. 62.)

From and after February 28, 1947, the defendants surrendered possession of the Murray Building and the rents were thereafter payable to the taxpayer. (R. 62.)

From the time he had conveyed the property to his attorneys in 1932 until he regained possession in 1947, none of the rents from the property were paid to the taxpayer. During all this period, the rents were paid to those who were in possession. The rents were accounted for and applied to the mortgage indebtedness which the Watters Group had paid when they redeemed the property, or to the expenses of operating the property while they were in possession. (R. 68.)

During all years here material, the taxpayer kept his books and records, and filed his income tax returns on the cash basis. (R. 53.)

The taxpayer did not file income tax returns for any of the years 1937 to 1946, inclusive, prior to July 15, 1947. On that date, he filed returns for the years 1937 to 1946, inclusive, in which he reported business income (consisting of rent on the Murray Building), deductions for taxes, repairs and depreciation, and net business income in the amounts shown by the following tabulation (R. 62, 63):

Year	Rent	Taxes	And Other Repair Expenses	Deprecia- tion	Business Net Income
1937.....	\$11,225.00	\$ 2,055.78	\$ 472.22	\$ 2,347.62	\$ 6,349.38
1938.....	9,350.00	1,835.86	222.68	2,347.62	4,943.84
1939.....	8,125.00	1,941.18	155.63	2,347.62	3,680.57
1940.....	8,771.40	1,911.03	733.88	2,347.62	3,778.87
1941.....	8,500.00	1,817.13	101.07	2,347.62	4,234.18
1942.....	8,100.00	1,808.86	1,182.04	2,347.62	2,761.48
1943.....	8,100.00	1,763.72	258.99	2,347.62	3,729.67
1944.....	9,450.00	1,944.54	165.71	2,347.62	4,992.13
1945.....	10,100.00	2,250.41	39.84	2,347.62	5,462.13
1946.....	11,109.32	2,686.23	94.62	2,347.62	5,980.85
Total.....	<u>\$92,830.72</u>	<u>\$20,014.74</u>	<u>\$ 3,426.68</u>	<u>\$23,476.20</u>	<u>\$45,913.10</u>

The rentals reported by the taxpayer in his returns for 1937 to 1946, inclusive, as summarized in the above tabulation, were the sums which were used in the accounting approved by the trial court, and the deductions for taxes, repairs and other expenses claimed in such returns are the sums included in the accounting approved by the court. However, through inadvertence, only \$155.71 was deducted as repairs and other expenses in the 1944 return in lieu of \$165.71. (R. 63.)

On March 15, 1948, the taxpayer filed his federal income tax return for the calendar year 1947 with the Collector of Internal Revenue, Portland, Oregon, and paid the amount of \$9.41, the tax shown to be due thereon. The reported business income consisted of the rentals shown for the months of January and February, 1947, in the accounting referred to above, and the rentals thereafter received by the taxpayer for the remainder of the year, depreciation of \$2,347.62, and an interest deduction in the amount of \$19,575.80, the difference between the interest credits and debits shown in the accounting. (R. 64.)

The Commissioner determined that the gross rents from the property for the entire period the taxpayer was deprived of possession amounted to \$102,589.45. Interest on these rents allowed the taxpayer in the accounting amounted to \$33,218.74, resulting in total gross receipts recognized of \$135,808.19. Against these credits, the taxpayer was charged with expenses of maintenance in the amount of \$25,501.01, and interest on the mortgage and the other disbursements amounting to \$52,794.54, or an aggregate charge of \$78,295.55. Subtracting these offsets from the credits above (\$135,808.19—\$78,295.55), the Commissioner determined that

the effect of the litigation and the accounting as shown above resulted in ordinary income to the taxpayer in the amount of \$57,512.64. (R. 69.)

The Tax Court agreed. It held that the taxpayer had realized ordinary income in the amount of \$57,512.64 in 1947, as a result of the termination of the litigation involving the Murray Building. The Tax Court held that the taxpayer did not constructively receive any of the rentals between the period 1942 to 1947. This conclusion was based on its findings that the taxpayer was out of possession of the Murray property until the conclusion of the accounting proceeding; that he had no control over the rents until he ultimately satisfied the balance in favor of the mortgagees; that no rents were set aside for or made available to him; that until the accounting proceeding was actually terminated, there was no definitive apportionment of the income from the property between the taxpayer and the mortgagees in possession, and the taxpayer had no right to demand payment of the rents and convert them to his own use. (R. 64, 74.)

SUMMARY OF ARGUMENT

The taxpayer realized income when, in the final accounting in the state court litigation, he was credited with the rents (and interest thereon) collected by the mortgagees in possession and the sum thereof was applied against the amount owing to the mortgagees. In substance, the credit in the accounting procedure utilized by the state court should be regarded as if the taxpayer had recovered a judgment for the rents and interest. Furthermore, by payment of the balance owing to the mortgagees, as determined by the final accounting, the taxpayer effected repossession of his

property and thus procured for himself an economic satisfaction from the application of the credit.

The full amount of the net rentals and interest reflected in the credit was taxable income in 1947. The taxpayer was on the cash basis. He did not actually or constructively receive any of the amounts in question in any prior year. The final accounting was not concluded until 1947, and the practical benefit to the taxpayer of the credit in his favor determined therein was contingent upon payment of the balance owing to the mortgagees.

ARGUMENT

The Tax Court Correctly Held That the Taxpayer Realized Income in 1947 in the Amount of the Net Rentals Credited to Him in the Final Accounting in His Suit to Establish His Right to the Murray Property and the Profits Therefrom

A. Preliminary

The issues involved in this case are simply (1) whether the taxpayer realized income in the amount of the net rentals credited to him in the final accounting of his suit to recover title and to procure an accounting of profits, and (2) if so, when the income was realized. As to (1), the Tax Court held that the taxpayer realized ordinary income in the amount of \$57,512.64 (R. 64) "as a result of the termination of the litigation involving the Murray Building". In the accounting ordered by the state court, the taxpayer was credited with rent and interest for the period from 1936 until 1947. In the view of the Tax Court (R. 71)—

The fact that the rents were realized only after great delay and then through the medium of a judicially ordered accounting proceeding *does not*

change the character of rent from a tax viewpoint. (Italics supplied.)

As to (2), the Tax Court held, upon the following rationale (R. 73-74), that the full amount of the net rentals was taxable in 1947 to the cash basis taxpayer: Until the accounting procedure was actually terminated in 1947, there was no definitive apportionment of the income from the property between the taxpayer and the mortgagees in possession. The taxpayer was still out of possession. He had no control over the rents until, pursuant to the state court decree, he ultimately satisfied the balance in favor of the mortgagees. Prior to 1947, he had no right to demand payment of the rents from the property and convert them to his own use. During the period 1942 to 1947, the rents were not set aside for or made available to him. He was therefore (R. 74) "not in constructive receipt of the rents from his property during the period involved in the accounting".

As the Tax Court has noted, and as the protracted state court litigation involving the Murray property indicates, this case (R. 66) "involves the tax treatment of a rather complicated real estate transaction". Nevertheless, the facts pertinent to a consideration of the issues here present a relatively simple picture. In 1928, the taxpayer * executed a first mortgage on the property in question. In 1932, he conveyed the property to the Conger Corporation, the *alter ego* of attorneys to whom he was indebted. In 1935, the first mortgagee foreclosed and bought in the property for

* Since the taxpayer's wife died in 1938, and he succeeded to her interest in the Murray property, the facts are related as if the taxpayer alone was involved.

approximately \$57,000. In 1936, the Conger Corporation gave notice of an intention to redeem. On the last day of the redemption period, however, it assigned the right of redemption and delivered a deed to the Watters Group. The Watters Group thereupon redeemed the property by payment of approximately \$63,000, and entered into possession. Subsequently, at public sale, it paid off a federal income tax lien on the property. It claimed to be the owners in fee of the property, free from any claim of the taxpayer. In 1938, the taxpayer commenced suit to establish his ownership of the property and to require the defendants (the attorneys and the members of the Watters Group) to render an accounting. In 1940, the state court held against the taxpayer, and he appealed. On June 30, 1942, the Supreme Court of Oregon (*Murray v. Wiley*, 169 Ore. 381, 127 P. 2d 112) reversed the Circuit Court, holding, in effect, that the Watters Group were mortgagees in possession, that the taxpayer was the beneficial owner of the property, and that upon payment of the amounts of the liens of the defendants he was entitled to a reconveyance of the property. The case was remanded for a full accounting, covering, among other things, all dealings by the Watters Group as mortgagees in possession. The Circuit Court subsequently determined that there was a balance due on the accounting of rents and profits in favor of the defendants and it entered judgment against the taxpayer. This decision was appealed by both parties. On January 14, 1947, the Supreme Court of Oregon, in *Murray v. Wiley*, 180 Ore. 257, 176 P. 2d 243, sustained the lower court's accounting conclusions, and remanded for an additional accounting to bring the decree up to date. The final accounting showed that for the over-all period

from March 23, 1936, to February 28, 1947, the taxpayer owed the Watters Group the sum of \$10,640.31. On the latter date, the taxpayer paid this amount and entered into possession of the Murray property. Pursuant to the mandate of the Supreme Court, the Circuit Court thereupon entered a final decree declaring that the taxpayer had fully satisfied all liens upon the property and was entitled to reconveyance of the legal title.

B. The amount of the net rentals credited to the taxpayer in the final accounting constituted his taxable income

In arriving at the balance of \$10,640.31 in favor of the defendants in the state court litigation, it is undisputed that the taxpayer was credited with the sum of \$135,808.19, representing gross rents collected by the mortgagees in possession, plus interest, for the period March 23, 1936, to February 28, 1947. Items totaling \$78,295.55 constituted proper charges against gross rents for the same period. These were maintenance expenses (\$25,501.01) paid by the mortgagees in possession, and interest thereon (\$8,273.31); interest on the \$3,152.95 lien (\$1,862.36); and interest on the amount paid by the mortgagees in possession in the exercise of the equity of redemption (\$42,658.87). (R. 61, 69.) Accordingly, the amount of the net rentals credited to the taxpayer in the final accounting (\$135,808.19 minus \$78,295.55) was \$57,512.64.

The Tax Court correctly concluded that this amount, "without question" (R. 71), was ordinary income to the taxpayer. An elementary principle in taxation is that tax consequences must depend on the substance of

a transaction, notwithstanding the form in which it is cast. Realities are to control and the form may be pierced to get at the real substance and effect of what has been done. Cf. *Gregory v. Helvering*, 293 U. S. 465, 470; *Griffiths v. Commissioner*, 308 U. S. 355; *Harrison v. Schaffner*, 312 U. S. 579; *Commissioner v. Court Holding Co.*, 324 U. S. 331; *Bazley v. Commissioner*, 331 U. S. 737. Thus, despite the fact that in the state court proceedings judgment for \$10,640.31 was entered for the defendants only, a proper analysis of the final accounting leading up to the decree requires the conclusion that the taxpayer in effect recovered in the litigation the sum of \$135,808.19, of which \$57,512.64, representing net rentals plus interest, was taxable as ordinary income under Section 22 (a) of the Internal Revenue Code of 1939 (Appendix, *infra*). If, for example, the rents collected by the mortgagees in possession, plus interest, had exceeded the amounts of the liens in their favor, and a judgment for the difference had been entered in favor of the taxpayer, it could hardly be denied that the recovery, to the extent it reflected net rentals plus interest, was ordinary income. And if, pursuant to the final accounting and decree in this case, there had been an exchange of checks between the taxpayer and the defendants, and the taxpayer had been paid directly the sum of \$135,808.19, it would have been made unnecessarily obvious that the taxpayer was recovering rents and interest.

But, as the Tax Court observed (R. 71), the fact that the recovery was effected through the mechanics of the judicially ordered accounting proceeding, in which it was determined that the amount owing by the taxpayer exceeded the amount owing to him, does not alter the

character as *rents* of what was in essence the taxpayer's recovery. Cf. *Brown v. Commissioner* (C.A. 7th), decided March 2, 1955 (1955 P.H., par. 72,468); *Palm Beach Aero Corp. v. Commissioner*, 17 T.C. 1169; *Hyde Park Realty v. Commissioner*, 211 F. 2d 462 (C.A. 2d). In *Brown v. Commissioner*, *supra*, for example, it was held that certain amounts credited by a lessor to a lessee constituted the lessor's income, as rents, where the lessee had improved the demised premises under the provisions of a lease which provided that the lessor would pay for part of the improvements by crediting the lessee for rental due under the lease.

The only practical and realistic view of the final accounting in the state court litigation in the instant case is to regard it as if the full amount of the rents and interest had first been paid over to the taxpayer, and then applied by him against the amounts of the mortgagees' liens on the property, or, in other words, as if the state court had rendered a separate judgment for the taxpayer. In this proper light, it follows that the taxpayer realized income. The taxability of what is in essence the principal amount of the recovery in a law suit depends upon the nature of the claim asserted and the basis of recovery. If, as was undeniably the situation here, the claim is for rents and profits, the recovery constitutes gain—a substitute for what otherwise might have been earned—and is taxable. *H. Liebes & Co. v. Commissioner*, 90 F. 2d 932, 935 (C.A. 9th); *Raytheon Production Corp. v. Commissioner*, 144 F. 2d 110, 113 (C.A. 1st), certiorari denied, 323 U. S. 779; *Triplex Safety Glass Co. v. Latchum*, 44 F. Supp. 436 (Del.), affirmed, 131 F. 2d 1023 (C.A. 3d); *Arcadia Refining Co. v. Commissioner*, 118 F. 2d 1010, 1011 (C.A. 5th);

Swastika Oil & Gas Co. v. Commissioner, 123 F. 2d 382 (C.A. 6th), certiorari denied, 317 U. S. 639; *Durkee v. Commissioner*, 162 F. 2d 184 (C.A. 6th); *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 363-364; *United States v. Safety Car Heating Co.*, 297 U. S. 88, 93-94; *Hort v. Commissioner*, 313 U. S. 28, 30-31.

There is an additional and equally cogent reason why the Tax Court's conclusion that the taxpayer realized income in the amount of \$57,512.64 must be sustained. Section 22 (a) of the Code, as has been frequently noted, was drafted in the broadest possible terms, and encompasses the full sweep of the constitutional power of Congress to tax income from whatever source derived. *Irwin v. Gavit*, 268 U. S. 161, 166; *Douglas v. Willcuts*, 296 U. S. 1, 9; *Helvering v. Midland Ins. Co.*, 300 U. S. 216, 223; *Helvering v. Clifford*, 309 U. S. 331, 334; *Helvering v. Stuart*, 317 U. S. 154, 169, rehearing denied, 317 U. S. 602; *Commissioner v. Smith*, 324 U. S. 177, 181, rehearing denied, 324 U. S. 695. A realization of taxable income is not confined to instances where cash is received, either actually or constructively. Section 22 (a) is broad enough to include an economic or financial benefit conferred, whatever the form or mode by which it is effected. *Commissioner v. Smith*, *supra*, p. 181; *Helvering v. Bruun*, 309 U. S. 461; *Old Colony Tr. Co. v. Commissioner*, 279 U. S. 716, 729. As stated in *Helvering v. Horst*, 311 U. S. 112, 116—

But the rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received pay-

ment of it from his obligor. * * * This [realization] may occur when he has made such use or disposition of his power to receive or control the income *as to procure in its place other satisfactions which are of economic worth.* (Italics supplied.)

In the instant case, it is clear that the application of the credit for rents and interest against the amount owing to the mortgagees in possession conferred an economic benefit upon the taxpayer and procured for him a satisfaction of economic worth. The Supreme Court of Oregon had determined that the taxpayer was entitled to a reconveyance of the Murray property, but only upon payment of the amount determined by the accounting to be due the mortgagees in possession. It was not mandatory for the taxpayer to pay the balance owing according to the final accounting, and to repossess the property. In fact, the Supreme Court had expressly provided that if the taxpayer defaulted in the payment of the balance of \$10,640.31, the Circuit Court was to specify a reasonable time within which the taxpayer might redeem or be forever barred by the dismissal of his suit. But, immediately upon service of the final accounting, the taxpayer paid the \$10,640.31 into court. When this was done, the full amount credited to him in the accounting and applied against the amount of the mortgagees' liens, procured for him the repossession of his property. This was an economic satisfaction (cf. *Brown v. Commissioner, supra*), and to the extent, in effect, that the taxpayer thus made use of his right to receive or control the rents and interest credited to him, he realized taxable income.

The essence of the taxpayer's argument (Br. 16-25) is that the amounts of rents and interest credited to the

taxpayer in the final accounting do not constitute taxable income because the taxpayer had no *personal liability* for the balance determined to be owing to the mortgagees. In this regard, the taxpayer attempts to apply the principle that no taxable income results from the cancellation of an indebtedness which is not the personal obligation of the taxpayer involved. But this principle is not applicable here. This case does not involve a cancellation of indebtedness, but, more accurately and realistically, the receipt of amounts owing by the mortgagees to the taxpayer (in effect received by the taxpayer through the accounting device as taxable rents and interest) and their application against the larger amount owing by the taxpayer to the mortgagees. Viewed in this light, the fact that the taxpayer was not personally responsible for the payment of the \$10,640.31 balance owing to the mortgagees is immaterial. The fallacy of the taxpayer's approach is that it ignores completely the substance of the accounting transaction as we have described it above, and, in effect, makes the end result of the accounting procedure controlling.

The taxpayer relies heavily (Br. 23-25) upon *Hilpert v. Commissioner*, 151 F. 2d 929 (C.A. 5th). In that case, the Tax Court (*Hilpert v. Commissioner*, 4 T.C. 473), Judge Arundell dissenting, had held, among other things, that a certain sum representing net rentals received by a mortgagee and allowed to the mortgagor by the court as a credit on redemption was ordinary income to the mortgagor as a (p. 477)—

species of postponed or delayed income—the net proceeds from the rental of property covering a number of years—which, due to the peculiar cir-

cumstances, was received in accumulated form in the tax year in issue.

The Court of Appeals reversed, but, *as Judge Arundell himself has pointed out in the instant case (R. 72-73)*—

There were circumstances in the *Hilpert* case which influenced the Fifth Circuit considerably in reversing our decision in that case. For example, Hilpert had treated the original transfer of the property to his mortgagee as a sale and had paid a tax accordingly. He also sold the property after having successfully contended before the Florida courts that the original transfer was a mortgage and not a sale, and he paid another tax on that transaction. The Fifth Circuit observed that the practical effect of our decision was to tax the same sale twice. *The facts which influenced the Court of Appeals in the Hilpert case are absent in the instant proceedings and we do not think that that decision should be regarded as at all binding on us.* (Italics supplied.)

Even in the absence of the facts in the *Hilpert* case which persuaded the court to rule against the Commissioner on the issue common to that case and the instant case, we would submit that the *Hilpert* decision should not be followed, and that the dissenting view of Judge Hutcheson therein (p. 934), sustaining on principle the taxability of the credit to the mortgagor, is the correct view.

C. The full amount of the net rentals and interest credited to the taxpayer in the final accounting constituted his taxable income in 1947

The taxpayer was on the cash basis. As observed in *Nitterhouse v. United States*, 207 F. 2d 618, 619 (C.A. 3d), certiorari denied, 347 U.S. 943, rehearing denied, 347 U.S. 970, it needs no collection of authority to establish the proposition that taxpayers on a cash basis pay income tax on what they have received during a taxable year. Prior to 1947, however—when, in effect the \$57,-512.64 was for the first time brought under his control by his satisfaction of the balance in favor of the mortgagees—it is clear that the taxpayer had not himself actually received the amounts in question. Nor had he received them constructively, as he now apparently concedes. (Br. 27.) True, the 1942 decision of the Supreme Court of Oregon established that the taxpayer was the beneficial owner of the Murray property and directed its reconveyance to him, but this was to be done only after an accounting had established the balance owing to the defendants in the litigation and upon the payment of that balance by the taxpayer. Thus, as the Tax Court observed (R. 74):

Until the accounting proceeding was actually terminated [in 1947], there was no definitive apportionment of the income from the property between the petitioner and the mortgagees in possession, and petitioner had no right to demand payment of the rents from the property and convert them to his own use.

In the circumstances, the taxpayer was not in constructive receipt of the rents from his property at any time

from 1942 to 1947. They had not been credited to or set apart for him or made available for him to draw upon without substantial limitation or restriction as to the time or manner of payment or condition upon which payment was to be made, and, until 1947, their receipt was not brought within his own control and disposition. Treasury Regulations 111, Sec. 29.42-2, Appendix, *infra*.

Furthermore, until 1947, when the taxpayer actually paid the accounting balance of \$10,640.31 to the mortgagees, it was not at all certain that he would derive any economic satisfaction and thus realize any income from the application of the rents and interest to the amount of the liens on the property. This was apparent from the order of the Supreme Court of Oregon in 1942 (R. 59), and again in 1947 (R. 61), that unless the taxpayer redeemed the property from the liens of the mortgagees, a reasonable time should be specified within which the taxpayer might redeem or be forever barred by the dismissal of his suit. Thus, not only was the amount of the taxpayer's credit uncertain until 1947, but the actual credit itself was contingent upon payment of the balance owing to the mortgagees. As the Tax Court observed (R. 74), the taxpayer could not have been compelled to pay a tax, during the period from 1942 to 1947, "on something that he might never receive." Cf. *North American Oil v. Burnet*, 286 U.S. 417, 423. Accordingly, the Tax Court was correct in holding that the full amount of the net rentals and interest constituted taxable income ^{*in*} on its entirety in 1947, when, upon termination of the accounting proceeding, there was a definitive apportionment of the income from the property between the taxpayer and the mortgagees in possession, and

when the contingency for the realistic application of the credit to the taxpayer was met. Cf. *United States v. Safety Car Heating Co.*, 297 U.S. 88, 93-94, rehearing denied, 297 U.S. 727; *Lucas v. American Code Co.*, 280 U.S. 445, 451, 452; *North American Oil v. Burnet*, *supra*; *Lucas v. North Texas Co.*, 281 U.S. 11, 13; *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 363; *Harbor Plywood Corp. v. Commissioner*, 14 T.C. 158, 161, affirmed *per curiam*, 187 F. 2d 734 (C.A. 9th); *H. Liebes & Co. v. Commissioner*, 90 F. 2d 932 (C.A. 9th); *Boston Elevated Railway Co. v. Commissioner*, 16 T.C. 1084, 1105. In *Nitterhouse v. United States*, *supra*, condemnation proceedings were started in 1943, and in 1944 the United States deposited the sum of \$5,370 (an amount exceeding the taxpayer's basis for the land) in the court's registry on account of just compensation to be awarded the taxpayer in the proceedings. In 1946, the taxpayer received a judgment for \$18,825 and was paid the principal sum and interest in that year, which was held to be the taxable year. The taxpayer claimed that a portion of the gain allocable to the amount deposited in 1944 should be considered as 1944 income. The Court of Appeals rejected the contention, stating (p. 620):

* * * we do not think that this deposit was available to the taxpayer at his will only. To withdraw it would have required a court order. And to get that order the petitioner would have to show that he had a clear title to the land free from tax and judgment liens and so on.

Similarly, in the instant case, the taxpayer's right to any rentals and interest rested not only upon an adjudication as to his ownership of the property but also, as a

condition precedent, upon his compliance with the decree to pay to the defendants the amount owing to them, as determined by the final accounting.

The gist of the taxpayer's argument is that he did actually receive the rents in question because the mortgagees in possession collected them *as his agent*. But the taxpayer does not spell out the facts purporting to establish an agency in this case, and indeed, they do not exist. For although it may be true that under Oregon law the mortgagees in possession were required to apply the rentals collected against the lien indebtedness, the imposition by law of this limitation upon their disposition of the rents collected did not, *ipso facto*, create an agent-principal relationship between them and the taxpayer. Agency is a relationship which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control and consent by the other so to act. 1 Restatement of the Law of Agency, Section 1. The situation in the instant case obviously does not meet these qualifications. In this connection, the cases cited to support the taxpayer's hypothesis of agency (Br. 29) are inapplicable. Analysis of their facts clearly shows that in the claimed taxable years either a true agent-principal relationship existed, or the taxpayer had constructively received the amounts in question, or the amounts collected were used to discharge a personal obligation of the taxpayer involved. For example, in *Hopkins v. Commissioner*, 41 B.T.A. 1292, discussed by taxpayer at some length (Br. 30-31), there was an express agreement whereby one party was to retain possession of stock purchased for the taxpayer as security against moneys advanced. Dividends paid on the stock were explicitly found to

have been collected by that party for the taxpayer (p. 1298) :

The Griffiths and the Guardian were * * * nothing more nor less than *agents* of the petitioner to collect the income from the Buckeye stock and apply it as far as necessary to the discharge of the petitioner's obligations. * * * (*Italics supplied.*)

Nor do the so-called claim of right cases cited by the taxpayer (Br. 34, 35) have any application here. Taxability under the principle announced in those cases turns upon the actual receipt of income in the taxable period involved, with no restriction as to disposition, but subject to repayment in a subsequent period. However, in the instant case there was no receipt of income—actual, constructive or through an agent—and, indeed, no realization of income until 1947, when the amount to which the taxpayer was entitled as a credit in the accounting became fixed and certain, and when, because of his compliance with the mandate of the court to pay over the balance to the mortgagees as a condition of reconveyance, he acquired in effect, for the first time, the (R. 74) “right to demand payment of the rents from the property and convert them to his own use.”

CONCLUSION

The decision of the Tax Court is correct and should therefore be affirmed.

Respectfully submitted,

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MARCH, 1955.

APPENDIX

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition*.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

SEC. 42 [as amended by Sec. 114, Revenue Act of 1941, c. 412, 55 Stat. 687]. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

(a) *General Rule*.—The amount of all items of gross income shall be included in gross income for the taxable year in which received by the taxpayer unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 42.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.42-1. *When Included in Gross Income.*—

(a) *In general.*—Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. * * * If a person sues in one year on a pecuniary claim or for property, and money or property is recovered on a judgment therefor in a later year, income realized in the later year, assuming that the money or property would have been income in the earlier year if then received. * * *

* * * * *

Sec. 29.42-2. *Income Not Reduced to Possession.*

—Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition. * * *

